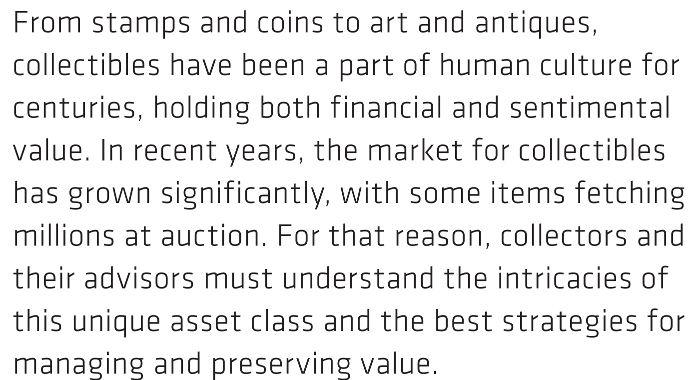
BERNSTEIN

Collections

Rare Finds Can Become Slippery Slopes for Wealth Transfer



From stamps and coins to art and antiques, collectibles have been a part of human culture for centuries, holding both financial and sentimental value. In recent years, the market for collectibles has grown significantly, with some items fetching millions at auction. For that reason, collectors and their advisors must understand the intricacies of this unique asset class and the best strategies for managing and preserving value.

People collect for various reasons, with aesthetics and passion being two of the most common. Collectors often develop emotional attachments to their pieces, making it challenging to handle and pass them down. Some collectors even attach an experiential approach to their collections, whether it be social gatherings surrounding a singular object or even traveling to view new items for potential acquisition. Many collectors want to ensure their pieces—and perhaps the non-financial values they ascribe to them—remain intact. As a result, complex choices arise when it comes to transferring the collection, whether during life or at death.

This paper explores the world of collectibles, including its various categories, investment challenges and opportunities, and best practices for estate planning and wealth management.

When Choices Abound

Determining who should receive a collection is one of the most prominent questions among collectors. Should family members inherit the collection, or would a donation to a museum or charity be more appropriate? Should the estate be equalized to account for family members who have no interest in an ownership stake? These and other decisions require careful professional planning and should not be taken lightly. While personal value may be uppermost when building a collection, as collectors contemplate the future, practical considerations will likely come to the fore.

Before delving into other aspects, it's important to note that for the purposes of estate planning, collectibles differ from other kinds of assets in fundamental ways:

Valuation

- They can be illiquid[1] and are not commonly traded day-to-day.
- Their value can be volatile and influenced by eclectic, idiosyncratic factors.
- Individual works are indivisible, and collections may be worth more if kept intact.

Maintenance

- Typically, they generate no income.
- The costs of insurance, transportation, storage, restoration, and display can be significant.

Taxation

- Because they are treated as "collectibles" by the IRS, long-term capital gains are taxed at a top federal rate of 31.8% (including the 3.8% net investment tax) rather than the 23.8% maximum long-term rate for securities.[2]
- Transactions involving collectibles—especially artwork—are subject to close scrutiny by two IRS bodies: Art Appraisal Services and the Commissioner's Art Advisory Panel.
- Tax deductions for donations to charity will depend not only on the items' value but also on the way you acquired them, the nature of the recipient organization, and how it intends to use them.

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The author of this piece wishes to express his sincere thanks to, and acknowledgment for, The Fine Art Group (www.fineartgroup.com) for their review and insight into this research.

1 "Liquid" in terms of investment markets typically refers to instruments that can be turned into cash in short order—usually within a one week time frame. While certain collectibles or collections may sell quickly, there are things to consider during an outright sale that could extend this time frame. We outline these considerations and the sale process on page 4.

2 Prior to the Taxpayer Relief Act (TRA) of 1997 the entire amount of net capital gains was taxed at a maximum rate of 28% with no distinction made for the type of long-term capital gain. The TRA reduced the maximum tax rate on net capital gains to 20% for most capital assets. However, as part of the TRA, Congress defined collectibles separately and chose to leave the maximum rate on collectible gains at 28%. A long-term collectible gain or loss is a gain or loss from the sale or exchange of a collectible held for more than one year.

A useful planning tool is to start with a checklist, which can be divided into emotional and financial considerations to help kickstart the process. For instance, educating intended beneficiaries on why the collection holds such meaning can be extremely useful. Do the beneficiaries share those same passions? If so, do they plan to keep the collection intact?

Asking these questions allows collectors to stress the importance of other planning considerations such as storage, security, insurance, and the like. If the beneficiary does not share in the same passions, do they wish to only benefit from the sale upon receipt, and how should that be managed? All of these items can be addressed proactively to guide the process. After laying the groundwork, collectors may want to add other items to their checklist, particularly if they plan to include collectibles in their estate plan. A more complete list of considerations can be found below:

Non-Financial

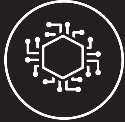
- ☐ Understand beneficiaries' feelings and views toward owning the collection
- ☐ Create an inventory of holdings (medium, dimensions, signature, creation date, cost, etc.)
- ☐ Educate beneficiaries on the collection (storage requirements, security, insurance, maintenance, the story of acquisition, etc.)
- ☐ Consider philanthropic options: if you're interested in donating your collection, consult with philanthropic advisors and charities of interest

Financial

- ☐ Categorize items as high financial value versus those having more sentimental than monetary value
- ☐ Obtain a fair market valuation (FMV) appraisal
- ☐ Organize records, receipts, bills of sale, past appraisals, insurance reports, and evidence of ownership
- ☐ Update your estate plan: make sure your estate plan reflects your wishes for your collection

The Collectibles Market

The collectibles market is currently booming and recent data suggest the area will be ripe for future planning conversations. Consider that sales of collectible cars at the Palm Beach Auction reached over $59.6 million (a new record[3]) in April 2022, while sales of rare whisky rose 23% that same year.[4] What's more, one of the art market's leading indicators—Art Basel and UBS Art Market Report of 2023[5]—forecasts an increase in both art prices and the value of individual artists again in 2023. This report also began tracking the rise of digital tokenized art, also known as NFTs, a few years ago. While the volume and value of NFTs saw an incredible rise, it has cooled slightly in late 2022 and more significantly into 2023.



What Are NFTs?

In short, NFTs, or non-fungible tokens, are data that represent an item—whether digital or physical—that cannot be replicated on a cryptographic blockchain. In other words, it creates a way for NFT owners to make an indisputable claim. Since NFTs use blockchain technology, similar to cryptocurrency, they are generally considered safe. What's more, the value is recorded on the blockchain at the point of sale, providing clear evidence of cost basis. Using NFTs in art collecting also establishes provenance or proof of origin. This authenticates the NFT, which is critically important for collectors who are assured they aren't holding counterfeit art and remain the sole owner of a given piece.

According to IRS Notice 2023-27, the IRS intends to use a "look-through" analysis to determine if an NFT will be treated as a collectible. Put simply, if an NFT represents a work of art, it will be treated as a collectible since art is classified as such according to the code.

Fractional Art Market

Recently, the rise of investment platforms that offer fractional shares of art—like Artex, Masterworks, and Mintus—has opened the art market to non-accredited investors. These platforms function similarly to ETFs or mutual funds, allowing ownership of fractional shares of art. Participants also gain access to an alternative asset class that is uncorrelated to traditional stocks, bonds, and commodities. However, the downside is that individuals do not own the physical art and cannot display it. Additional drawbacks may include extra fees, such as management fees, purchase fees up to 10%, and performance fees up to 20% if profits are made.[6]

Due Diligence and the Acquisition Process

Lack of due diligence on the part of the collector can lead to a rise in an inflated sense of value for pieces within the collection or the collection itself. For example, some collectors may spot an item they have been on the lookout for, and in their haste to acquire the item they offer a premium to purchase right away. Without the proper due diligence, this can lead to a subpar outcome. In other words, the purchase price of the item does not always equal the fair market value of the item at time of purchase and it's possible the collector will see their new item decrease in value.

3 Barrett-Jackson Media. (April 20, 2022). Barrett-Jackson Topples Palm Beach Auction Records with $60.7 Million in Total Sales, Including $3.8 Million for Charity and Hosts Florida Governor Ron DeSantis to Help Raise $1.76 Million in Support of Ukrainian Relief Efforts. https://www.barrett-jackson.com/Media/Home/Reader/barrett-jackson-topples-palm-beach-auction-records-with-60-7-million-in-total-sales-including-3-8-million-for-charity-and-hosts-florida-governor-ron-desantis-to-help-raise-1-76-million-in-support/

4 Noble and Company (UK) Ltd. (2022). Whisky Intelligence Fine & Rare Whisky Auction Market Report 2022. https://nobleandcompany.com/wp-content/uploads/2022/11/Noble-Co-Whisky-Intelligence-2022.pdf

5 Art Basel and UBS. (2023). The Art Market 2023. https://theartmarket.artbasel.com/

6 Abby Schultz, Buying a Piece of Art-Market Hype, June 2023. https://www.barrons.com/articles/buying-a-piece-of-art-market-hype-7c1ba913

Navigating the Sales Process

Whether you are a collector who wants to sell a few pieces of art, jewelry, or valuable collectibles, an executor faced with the fiduciary duty of monetizing an estate, an heir who has inherited pieces they don't want or need, or an institution deaccessioning pieces that no longer fit the mission—the sales process can be daunting, complex, and even emotional. Having an independent advisor by your side to guide you through the sales process can ensure successful results and help answer important questions like:

1. What valuable assets do you have and do you understand their value?
2. What time of year should your assets go up for sale?
3. What sales venue is the most appropriate for your assets?
4. Are the provided sales estimates accurate?
5. Are the sales fees negotiable?
6. How does the sales venue intend to advertise and market your assets?
7. Will there be any transport restrictions on your items?
8. Do you have insurance?
9. What are the sales terms and conditions, and can you negotiate?
10. Should your assets be sold as a single owner sale or part of a specialty sale?

Planning for Collections

From a planning perspective, there are several ways to approach passing on a collection. Throughout the planning process the importance of obtaining valuations on the collection or pieces therein can not be understated. It is a critical component of any planning discussion and should be taken as such. These are generally broken down into the following broad goals:

1. Outright sale
2. Transfers to family or other non-charitable beneficiaries
3. Donations to charitable organizations

We will discuss each in turn, outlining various strategies that may be used to achieve these objectives.

Outright Sale

The first path to consider is an outright sale or exchange[7] during the collector's lifetime. In doing so, the seller must factor in the appropriate capital gain tax rate and retain proper documentation to establish a cost basis for the item(s) being sold. Now, let's explore the income tax considerations of an outright sale and some potential strategies for reducing it.

Income Tax Considerations

Compared to other capital assets, collectibles are subject to unique taxation under the current tax code and are defined for income tax purposes as any[8]:

- work of art;
- rug or antique;
- metal or gem;
- stamp or coin;
- alcoholic beverage;
- musical instrument; or
- historical objects.

Importantly, the IRS can deem any tangible property not specifically enumerated above as a collectible.[9] Thus, a person's whiskey library is as much a collectible as a trove of historical memorabilia and documents, as would be an Andy Warhol or Patek Philippe.

Collectors should also be aware that the income tax definition of a "collectible" applies not only to direct ownership of the asset but also to indirect ownership. For example, many investors are surprised to learn that precious metal ETFs (e.g., gold, silver, platinum, and palladium) are also considered collectibles and subject to a higher tax rate because they represent ownership in the underlying asset.[10] Further, the gains (but not losses) from the sale of passthrough entities (i.e., a partnership, S corporation, or trust) are considered collectibles to the extent the gain from the sale is attributable to unrealized appreciation in collectibles owned by the passthrough entity.[11]

7 Note that the Tax Cuts and Jobs Act of 2017 eliminates the ability of taxpayers to defer gain on all types of non-real estate personal property assets to include vehicles, trucks, and unfortunately, art and other collectibles via a Section 1031 exchange.

8 IRC §1(h)(5)(A) cross reference to IRC §408(m). The original intent of IRC §408(m) was to prohibit speculative asset investment in collectibles within an individual retirement account (IRA). IRC §408(m)(3) excludes certain metal coins and bullion from the definition of a collectible for purposes of IRA investments. However, IRC §1(h)(5)(A) explicitly denies the exception for gold and silver coins and bullion for income tax purposes. Prop. Regs. IRC §1.408-10(b) expands the definition in the code to include musical instruments and historical objects (documents, clothes, alcoholic beverages, etc.).

9 Prop. Regs. §1.408-10(b)

10 See IRS Program Manager Technical Advice 2008-01809 (5/2/08) https://www.irs.gov/pub/lanoa/pmta01809_7431.pdf.

11 IRC §1(h)(5)(B)

DISPLAY 1

	Dealer	Investor	Collector
Definition	Regularly buys and sells art as their trade/business	Buys and sells for profit, but it is not their sole business. Primarily concerned with the appreciation of the asset.	Collects as a hobby or pleasure
Tax Treatment (held more than one year)[12]	Ordinary Rates	Capital Gain @ 28%	Capital Gain @ 28%
Losses Deductible?	At Ordinary Rates	As Capital Loss	No

The income tax consequences of selling a collectible are also influenced by the taxpayer's status. For income tax purposes, a taxpayer may be classified as a dealer, investor, or collector (*Display 1*). Dealers are those taxpayers who regularly maintain an inventory or buy and sell collectibles as part of their trade or business. A taxpayer classified as a dealer is subject to ordinary income tax on gains, which could be as high as 37%, and can deduct their ordinary and necessary expenses from their trade or business.

Investors are taxpayers who purchase collectibles with an eye toward capturing appreciation in the items' value.[13] Investors are taxed on long-term capital gains from collectibles at a maximum effective rate of 31.8%. After 2025, investors will also be able to deduct ordinary and necessary expenses incurred in connection with their investment activities.[14]

Collectors purchase collectibles for personal pleasure. While they are taxed on long-term capital gains at the same effective tax rate as investors, they are disallowed use of any incurred losses under the hobby loss rules.[15]

The tax code and regulations lack a clear definition or bright-line test to distinguish between a dealer, investor, or collector. Additionally, taxpayers may fall into multiple categories. As a result, it's crucial for taxpayers to work closely with their tax advisors to ensure their actions and records align with their profit motives.

Charitable Remainder Trusts (CRTs)

When a collector wishes to sell their collection or specific pieces therein—but has a large capital gain tax hurdle to overcome—there is a viable solution. The income tax liability resulting from the sale of collectibles can be deferred by selling the assets through a charitable remainder unitrust, or CRUT. This approach is particularly beneficial for collectors with highly appreciated assets, as it allows them to avoid immediate capital gains tax while still receiving a steady stream of income.

The tax code and regulations lack a clear bright-line test to distinguish between a dealer, investor, or collector."

12 Note that each may still be subject to the 3.8% NIIT surtax as described previously.
13 See Wrightsman v. United States, 28 F.2d 1316 (Ct. Cl. 1970).
14 IRC §67(g). The Tax Cuts and Jobs Act of 2017, Pub. L. No. 115-97, add IRC §67(g), which suspends miscellaneous deductions for tax years 2018 through 2025
15 IRC §183

Under this approach, the donor transfers appreciated assets, such as collectibles to the trust. Upon the asset's sale, the grantor receives income from the trust for either their lifetime or a fixed period. Then, at the trust's termination, any remaining assets will pass to designated charities. By utilizing a CRUT, collectors can potentially increase their income and reduce their tax burden while supporting cherished causes.

When funding a CRUT with collectibles, one particular kind of charitable remainder trust stands out—the "flip net income with make-up charitable remainder unitrust", or Flip-NIMCRUT. A Flip-NIMCRUT can be structured to delay the donor's income payout until the sale proceeds become available, hence the "flip."

Assume a 65-year-old couple wishes to sell a $10 million piece of art with a cost basis of $1 million. The pair live in a state with no state income tax and will be subject to the 3.8% net investment income tax. An outright sale would trigger a tax bill of 31.8% on $9 million of gain, or $2.86 million, leaving them with $7.14 million to invest.

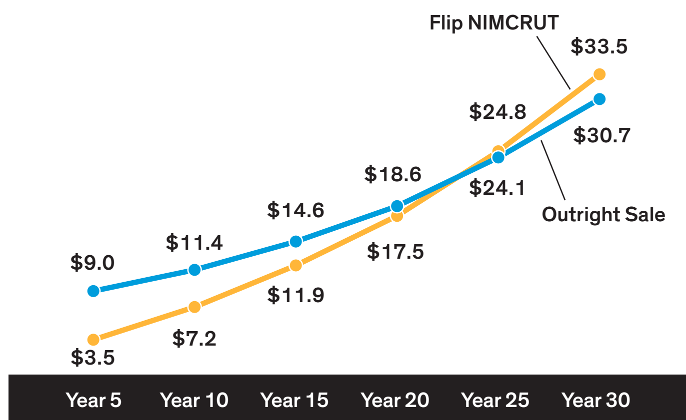
Alternatively, the couple could fund a Flip-NIMCRUT with the artwork prior to its sale, receiving an upfront charitable deduction based on the asset's cost basis at funding. The trustee could then sell the art without the trust immediately recognizing any gain. That means the entire $10 million of sale proceeds could be reinvested to support a lifetime payout to the pair.

To facilitate a 10% joint lifetime payout, assume that the proceeds are invested in 80% stocks and 20% bonds. The trust distributions will deliver income to the couple in the following order: ordinary income, capital gains, and other income followed by non-taxable corpus of the trust.[16] Within those tiers, income is treated as distributed first from the class subject to the highest federal income tax rate down to the lowest. In other words, at 28%, the "collectibles" capital gain income will come out before any other capital gain income within that particular tier.

Over a 30-year time frame, our analysis quantifies the benefit per $10 million of funding for using the Flip-NIMCRUT as an additional $2.8 million in the donor's personal portfolio in typical markets, or approximately $600,000 more in poor market conditions (*Displays 2 and 3*). Depending on market conditions, that will still leave between $1.0 and $2.9 million for charity at the end of the term. As this demonstrates, a Flip-NIMCRUT can be a powerful planning tool.

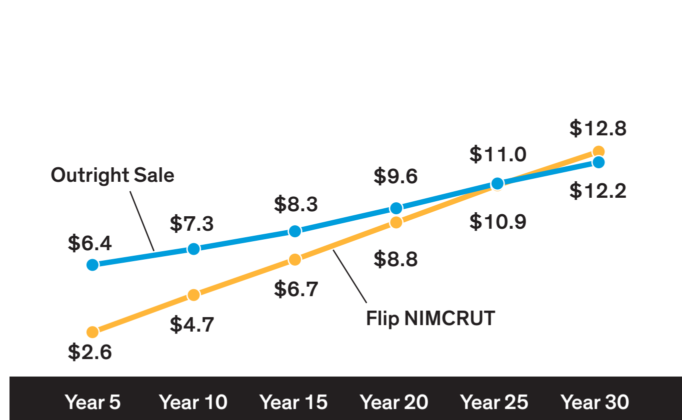
DISPLAY 2: DONOR'S PERSONAL WEALTH

Typical Markets* (USD Million)



DISPLAY 3: DONOR'S PERSONAL WEALTH

Poor Markets† (USD Million)



*"Typical Markets" means 50th percentile results of 10,000 trials in our Wealth Forecasting System. Based on AB's estimates of the range of returns for the applicable capital market (as of 06/30/23) over 30 years.

†"Poor Markets" means the 90th percentile results of 10,000 trials in our Wealth Forecasting System. Based on AB's estimates of the range of returns for the applicable capital market (as of 06/30/23) over 30 years.

Both the proceeds from the outright sale and the FLIP NIMCRUT portfolios maintain an asset allocation of 80% Stocks and 20% Bonds throughout.

The terms of the CRUT are as follows: Joint life CRUT for a 65-year old couple, paying 10% annually, created at a 7520 rate of 5.8%. The initial asset is modeled with $1.0 million basis in both situations.

Data do not represent past performance and are not a promise of actual or range of actual future results.

16 IRC § 664(b)

Transfers to a Family Member or Other Non-charitable Beneficiary

Transferring collectibles to family members or other non-charitable beneficiaries through lifetime gifts provides certain tax benefits. Under current law, each US citizen or permanent resident may give away up to $13.61 million free of federal gift and estate tax during life and/or at death, adjusted annually for inflation. Barring future action by Congress, this amount will be halved on January 1, 2026—leaving a forecasted federal exclusion amount of $6.8 million (the "residual amount").

An individual can only preserve the "excess amount" of the current federal exclusion—the portion that exceeds the residual amount—by using it prior to expiration. Importantly, the residual amount must first be applied to any taxable gift. That means only individuals who make aggregate taxable gifts exceeding the residual amount prior to 2026 will benefit from some or all of today's higher level.

Current law levies a 40% tax on transfers in excess of an individual's then-remaining exclusion amount. Under this system, the lifetime transfer of an individual's collectibles may (i) remove any post-transfer appreciation in the asset's value from the individual's taxable estate and (ii) help utilize the individual's excess exclusion prior to its scheduled 2026 drop.

With that said, a lifetime gift has certain drawbacks. Assets gifted during life do not benefit from the same basis adjustment as assets included in an individual's taxable estate at death. Instead, the recipient assumes the original owner's cost basis (otherwise known as "carryover basis"), along with any built-in gain. As a result, a future recognition of such gain may prove especially painful due to the higher 28% capital gains tax rate applied to collectibles and potential exposure to the 3.8% net investment income tax. State capital gain rates may also apply. For that reason, it's important to consider all potential tax implications when structuring a lifetime transfer.

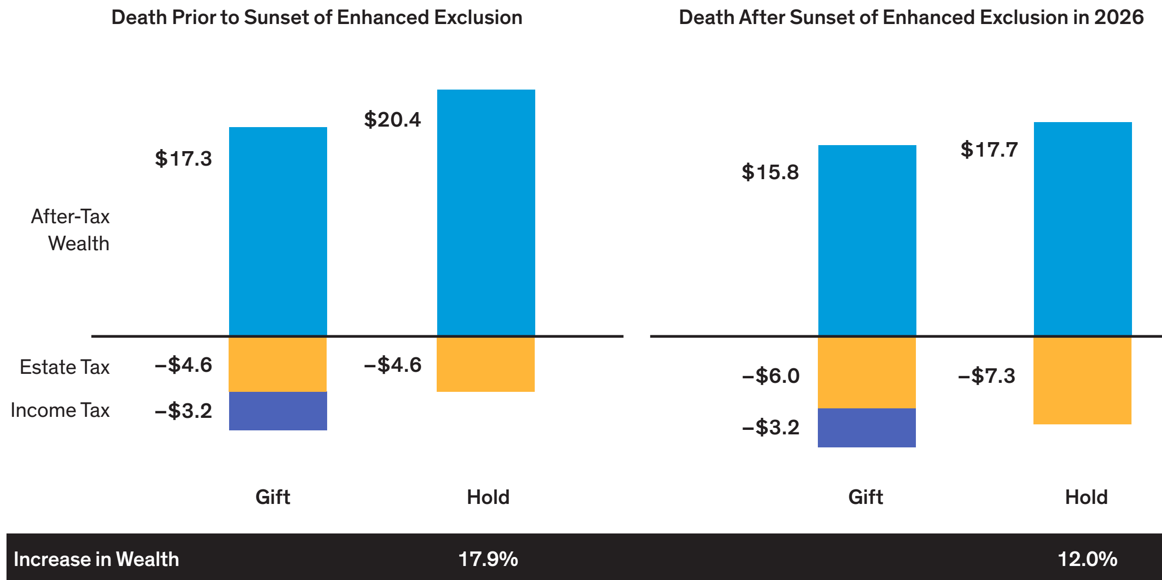
Consider a collection currently worth $10 million, with little to no cost basis, which is part of an individual's $25 million estate. Based on current law, the collector would owe estate tax on the $11.39 million that exceeds the lifetime exclusion amount ($25 million minus $13.61 million). Leaving state estate tax aside, their tax bill would be $4.56 million (40% of $11.39 million). Since it's included in the estate, the collection could receive a step-up in basis to fair market value and the heir could sell it with little (if any) tax bite. This would leave the beneficiary with $20.44 million after tax.

But what if the individual made a lifetime gift of the collection to an heir for immediate sale instead? The heir would face a $3.18 million income tax liability[17] that could have been eliminated by including the collection in the original owner's taxable estate. What's more, the owner would only have $3.61 million exclusion remaining (since $10 million was used for the original gift). That means $11.39 million of the remaining $15 million estate would be subject to estate tax—which results in the same $4.56 million estate tax liability as above.[18]

17 ($10 million x 28%) + ($10 million x 3.8%)
18 Assumes that the beneficiary was to sell the collection either way and that the collector died during the current favorable tax law environment

DISPLAY 4: ALLOCATION OF WEALTH

(After Estate and Income Taxes)



Increase in Wealth	17.9%	12.0%

Bernstein does not provide tax, legal or accounting advice. In considering this material, you should discuss your individual circumstances with professionals in those areas before making any decisions.

What if that individual gifted the collection today but died after the current law sunsets in 2026? As before, we'll assume the beneficiary sells immediately and pays $3.18 million in taxes. If there is no portfolio growth through the individual's 2026 death, the entire $15 million estate would be subject to the 40% estate tax since the $10 million gift would reduce the post-sunset applicable exclusion to $0. Net of the $6.0 million tax bill, the beneficiary would receive $9 million. When added to the net sales proceeds, the total after-tax value to the beneficiary would come to $15.82 million. In light of the sunset, the lifetime gift of $10 million allows the family to shelter an additional $3.1 million from the estate tax—a $1.24 million tax savings versus simply holding the collection for a step-up basis , as shown in *Display 4*.

Yet, in this case, the additional estate tax savings from making a gift before sunset fails to offset the additional income tax stemming from the lack of step-up in basis. If the collection remained in the estate until after the inflation-adjusted applicable exclusion resets to $6.8 million post-2025, the heirs would have been better off. For instance, applying the same assumptions as the previous example,[19] the estate would be facing an estate tax bill of $7.28 million,[20] leaving the beneficiary with $17.72 million or about 12.0% more wealth.[21]

For beneficiaries who intend to maintain or add to a collection over time, other factors might come into play. For instance, the collection's expected rate of return and the transfer method used by the donor could play more prominent roles. Additional wealth transfer techniques are also worth considering in conjunction with or in place of a completed gift.

19 No growth in the portfolio or the collection
20 ($25 million minus $6.8 million) x 40%
21 $25 million minus $7.28 million

The Valuation Conundrum

When comparing transfer options, one critical factor to consider is the valuation of pieces within the collection. This is a highly specialized field, and valuations can shift so dramatically that the purchase price may have little bearing on its current worth. In addition, knowing the piece's cost basis is vital when weighing potential trade-offs between lifetime gifts, transfers at death, and charitable bequests.

When making a gift or engaging in a non-arm's-length transaction, a collectible's value is subject to the "willing buyer and willing seller" rule. Put simply, the value is not based on a forced sale or a sale in a market where that collectible would not typically be sold. For example, the value of an automobile would be the price a similar car might command at a public auction—not the price an auto dealer would necessarily pay for a given vehicle.

The Appraisal Requirement

An appraisal report is required for estates with art and collectibles worth over $3,000 each or $10,000 for an aggregate collection. In addition, an executor certification must be attached to the appraisal.[22] In this written statement, the executor attests (under penalty of perjury) to the completeness of the itemized list of property as well as the appraiser's disinterested character and qualifications.

Artwork Appraisal Issues

All tax returns involving any form of artwork with a claimed value over $50,000 must be referred to Art Appraisal Services (AAS) for possible review by the Art Advisory Panel, which consists of 25 renowned art experts who help determine the fair market value of works submitted to the Internal Revenue Service.[23] Detailed records must be kept, including bills of sale, professional photographs, condition and provenance, and any exhibitions.

The latest figures from the AAS show that the Panel accepted 35% of the valuations submitted while adjusting the remaining 65%. Some values were lowered, although total adjustments as a percentage of claimed value were just 11% overall.[24] In other words, the IRS employs a very thorough process to determine artwork's value but usually does so retrospectively.

Valuations are also needed to quantify a charitable income tax deduction when the collection is donated to charity. In fact, under Code Section 170(f)(11)(C), Form 8283, an appraisal report is required for charitable contributions of art assets whose value exceeds $5,000. If an item or collection's value exceeds $20,000, the appraisal report must be attached to the tax return. The deduction for a lifetime charitable gift of art also depends on the way the art was acquired, the nature of the recipient organization, and the recipient's use of that donation after the fact.

Who can perform such valuations? The individual must meet certain criteria, including[25]:

- Must be a qualified appraiser—meaning they have a recognized appraisal designation from a recognized professional organization or meet relevant education/experience requirements
- Must perform paid appraisals and have experience valuing that asset (a baseball card appraiser is not likely to qualify as a wine or watch appraiser, etc.)
- Must have no conflict of interest—they cannot be the donor, recipient, or a party to the transaction where the donor acquired the property. Further, they cannot be employed or related to any of the aforementioned parties (whether through marriage or otherwise)
- Cannot appraise a work of art or collectible and then sell, or have sold, the same items

Obtaining an advanced ruling from the IRS for gift, estate, and income tax purposes is one way to help alleviate the time and expense involved in disputing valuations, especially when it comes to art. This IRS Statement of Value[26] is available for any artwork with an appraised value of at least $50,000, and once determined, the taxpayer should attach the ruling to their tax return. This document provides peace of mind that the item has been accepted at a known value, and any planning done with that item will not be subject to further valuation scrutiny when filing the relevant return.

22 Treas. Regs. § Reg 20-2031-6(b)
23 See IRM 4.48.2 and IRM 8.18.1.3
24 IRS (2021). The Art Advisory Panel of the Commissioner of Internal Revenue Annual Summary Report for Fiscal Year 2021. https://www.irs.gov/pub/irs-pdf/p5392.pdf
25 See Treas. Reg.§20-2031-6(b); and Joy Berus, The Art of the Valuation of Art, Antiques and Collectibles in an Estate, December 2008, Journal of Practical Estate Planning.
26 Revenue Procedure 96-15; 2018-01

Lifetime Transfer Strategies via Entities and Trusts

If a collector decides to gift today in a financially astute manner—perhaps capitalizing on the meaningful tax savings from today's higher exemption amounts—they may consider using a trust. However, this introduces complexity and should not be taken lightly. The trust agreement must appoint a trustee with experience in these matters, who is independent of the collector, in order to avoid any unintended inclusion of the assets into the estate. The trust should also allow the trustee to keep the contributed assets without pressure to diversify under the prudent investor rule.

Gifts to Irrevocable Grantor Trusts

Irrevocable grantor trusts are a popular strategy for shifting collectibles during a collector's lifetime and can be established through a sale or an outright gift to the trust. Irrevocable grantor trusts treat the trust's creator as the asset owner for income tax purposes, meaning any income the assets generate within the trust is taxable to the grantor. Some irrevocable trusts qualify as grantor trusts based on the grantor retaining certain rights, such as the ability to decide who receives the income or other such powers.[27]

Gifting assets to the trust allows for the assets to be removed from the grantor's estate, since the trust becomes the asset's owner from an estate perspective. In doing so, the grantor will likely need to gift additional liquid funds to the trust to pay for insurance and other related maintenance and expenses. While the grantor bears any income tax burden, those taxes do not count against the grantor's exclusion amounts referenced earlier. Additionally, the trust protects the collectible from the beneficiary's creditors. Finally, the trust document can direct the assets upon the grantor's death, making it a useful planning strategy. For example, the trust document could include language around the use of the collection, such as one heir enjoying the collection for some time before it passes over to another for their use and enjoyment.

In addition to or in place of gifting a collection to an irrevocable grantor trust, the owner may want to consider one of the following wealth transfer strategies.

Installment Sale to Irrevocable Grantor Trusts

An installment sale allows a collector to sell all or a portion of the collection to the trust in exchange for a promissory note. Under this strategy, the trustee agrees to make annual interest payments from the trust to the grantor for a specified term of years, followed by a final balloon payment of principal. Neither the sale nor interest payments to the grantor are subject to income tax since the transaction is between the same taxpayer (e.g., the grantor and an irrevocable grantor trust of which the grantor is the taxpayer). This strategy can be especially useful if the lifetime exclusion has been reached. As in the outright gift strategy, the grantor will likely need to contribute additional funds to the trust, especially in the event the assets do not provide sufficient liquidity to repay the interest on the note.

Leaseback Agreement

A leaseback agreement involves giving the collection to the trust and then leasing the items back via fair market rental payments, which are determined by an independent, qualified appraiser. This strategy can be designed as an irrevocable grantor trust strategy, or it can be done as a non-grantor trust where tax payments are made by the trust and not the grantor. Note that this arrangement comes with some risk. The use of this strategy has had little test against IRS rules and a rental value must be established in order to ensure payments are correct. As a controversial strategy with gray areas around it, having a qualified trustee is essential for undertaking this endeavor.

The trust agreement must appoint an independent trustee with experience in these matters in order to avoid any unintended inclusion of the asset in the estate."

Paired GRAT Strategy

Taxpayers can also leverage their liquid wealth to efficiently transfer illiquid wealth, like collectibles. Using a particular type of grantor trust—called a grantor retained annuity trust ("GRAT")—is especially helpful in this regard. A GRAT is a trust to which the grantor contributes assets but retains the right to receive fixed annuity payments for a specified number of years.[28] When the value of assets contributed equals the present value of the future stream of annuity payments, the remainder interest has a value of zero for gift tax purposes, and the GRAT is said to be "zeroed out" for transfer tax purposes.[29]

27 Internal Revenue Code §§ 671, 673-677

28 If the annuity interest is a "qualified interest" within the meaning of the Code, then the present value of that interest, discounted at the Section 7520 rate, is subtracted from the value of the initial contribution to the trust to determine the amount of any taxable gift.

29 Some estate planners design GRATs so that the present value of the remainder interest at inception is very small but greater than zero. Such a design allows the grantor to report the GRAT contribution on a gift tax return, which in turn causes the statute of limitations to run, limiting the amount of time that the Internal Revenue Service (IRS) has to audit the gift.

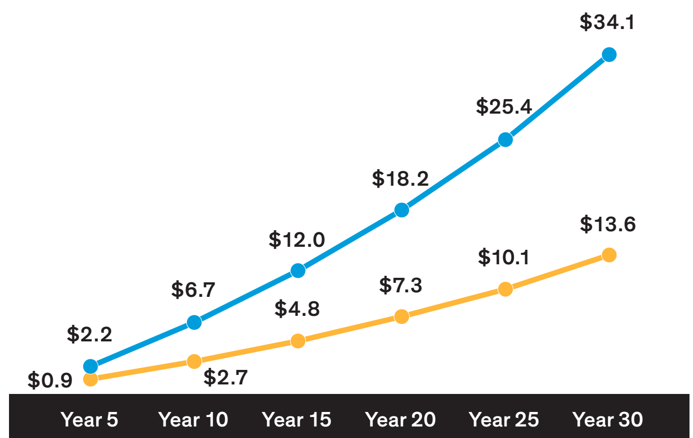
In a zeroed-out GRAT, there is no taxable gift at inception. During the annuity term, the grantor is the deemed owner of the GRAT for income tax purposes. If the grantor survives the annuity term, funds remaining in the GRAT pass directly or in trust to the beneficiaries without gift or estate tax.[30] However, if the grantor dies before the expiration of the annuity term, a portion or all of the trust assets will be included in the grantor's estate for estate tax purposes.[31]

A collector can utilize a series of short-term GRATs funded with marketable securities to transfer appreciation on the marketable securities to the irrevocable grantor trust over time. The funds from these GRATs can then be used to purchase art or a collection from the grantor using the installment sale strategy previously described. Alternatively, if the grantor has the power of substitution over the trust, they can transfer the collection to the trust in exchange for an equal value of marketable securities.

Consider a donor who funds a series of 2-year GRATs with $10 million in marketable securities today. Upon receiving the annual annuity payment(s), the grantor will immediately roll them into a new 2-year GRAT. This strategy is commonly called a "rolling" GRAT (rGRAT). Here, we'll assume each GRAT consists solely of a globally diversified portfolio of stocks, and the annuity payments are calculated using a section 7520 rate (i.e., discount rate) of 5.8%. Using our long-term median capital market forecast, we estimate the strategy would transfer up to $34.1 million in cumulative "wins" over 30 years (*Display 5*). In other words, the irrevocable grantor trust could purchase up to $34.1 million worth of collectibles from the grantor by year 30 without using any of the grantor's exclusion.

DISPLAY 5: CUMULATIVE GRAT WINNINGS

Typical Markets* (USD Million)



*"Typical Markets" means 50th percentile results of 10,000 trials in our Wealth Forecasting System. Based on AB's estimates of the range of returns for the applicable capital market (as of 06/30/23) over 30 years.

†Estate Tax Savings is calculated as the value of the cumulative GRAT remainder multiplied by the 40% estate tax rate.

The initial rolling GRAT strategy is implemented when the 7520 Rate is 5.8% and is funded with $10 million. All winnings from the rolling GRAT strategy are transferred to a grantor trust, which is modeled as 100% cash equivalents for purposes of this analysis.

Data do not represent past performance and are not a promise of actual or range of actual future results.

30 Although any wealth transferred should avoid both gift and estate tax, generation-skipping transfer (GST) tax may apply if the beneficiaries are "skip persons," such as the grantor's grandchildren. The GST exemption, which can be used to avoid the GST tax, cannot be applied to a GRAT until the end of the annuity term. See Code §2642(f).

31 Code §§ 2033, 2036; Treas. Reg. § 20.2036-1(c)(2).

Family Limited Partnerships (FLPs) and Limited Liability Companies (LLCs)

Another common suggestion is to create a family limited partnership (FLP) or limited liability company (LLC) and transfer the assets into this structure. This provides an opportunity to use shares of the FLP or LLC as the giving apparatus, rather than the actual collectible itself.

One advantage of this approach is that it allows the collector to appoint a manager to help with maintenance, insurance, and storage, among other things. It also avoids the donor having to give a single piece of the collection that may or may not appreciate at the same rate, creating disunity in the ultimate value of the gift.

For instance, if a donor wishes to pass three pieces of art to three separate individuals, using the FLP or LLC structure would mean that they own the pieces collectively as part of the partnership, rather than each person owning a 33% share and hoping that each piece reaches the same value. This ultimately benefits them together. Additionally, this type of planning structure may allow for valuation discounts due to the nature of their ownership interests and not owning the art itself. This could be extremely beneficial from an estate planning perspective, as discounted assets use less of the lifetime exclusion referenced earlier.

Potential Pitfalls of Lifetime Gifts

Lifetime gifts also have some drawbacks, with the most obvious being the loss of use and enjoyment of the collectible. Suppose you give ownership of a valuable painting to your child but continue displaying it in your home. Since you've retained an interest in the painting, the IRS may include the value of the painting in your estate. If your child cannot safely take custody, you may need to store it in a warehouse or temporarily lend it to a museum. Lending it would be a philanthropic act that would enhance public enjoyment—and potentially increase the painting's value due to heightened exposure. Alternatively, you could consider paying your child rent at fair market value to continue enjoying the item.

Sometimes, lifetime gifts lead to hurt feelings. Giving a valuable collectible to one family member over others could stir resentment and tension within the family. What's more, if the recipient decides to sell or dispose of the item in a way you disapprove of, further conflict could ensue. Finally, lifetime gifts may not be suitable if you are concerned about your future financial security. Once you transfer a valuable asset, you lose control and can no longer use it to generate income or raise cash.

Testamentary Transfer Options to Non-charitable Beneficiaries

Collectors may set in motion several planning strategies during life that could occur at their death—the most common being the sale of the collection, which may or may not be subject to estate tax depending on the size of the estate. When constructing an estate plan, the first question any collector or investor should ask is whether the collection should be sold at death or distributed in kind. If the intended recipients are more interested in the collection's value than the collection itself, directing the sale may allow the decedent-collector to maintain control by pre-selecting the auction house and general sale terms. At the same time, it will also allow the estate to take related sales expenses as a deduction. Since the collection's full market value is included in the estate, the owner should keep abreast of exclusion amounts, the collection's prevailing estimated value, and the overall estimated estate value in advance.

Giving a valuable collectible to one family member over others could stir resentment and tension within the family."

In some cases, the collection's value may cause the estate to be large enough that the liquid assets cannot pay the estate tax bill, which is typically due within nine months of death. Proper valuations ahead of time can alleviate this stress by ensuring adequate life insurance coverage as a potential solution to cover that portion. The risk of beneficiaries having to fire sale part of the collection to cover the bill should not be discounted. Another potential solution is to use the collection as collateral for a loan to pay the estate tax when due, allowing the estate more time to generate liquidity. Under certain circumstances, the present value of the loan's interest cost may be deductible for estate tax purposes.[32]

32 Prop. Treas. Reg. § 20.2053-3(d)(2). The use of a Graegin loan might also be worth considering but is beyond the scope of this paper. See Estate of Graegin v. Commissioner, T.C. Memo. 1988-477.

Charitable giving may be as simple as gifting to a museum or other charitable organization."

One important concept that estate planners and collectors need to be aware of when valuing art is "blockage discounts." Similar to the willing buyer/willing seller issue, blockage discounts go a step further when a large block or collection of items from one artist is involved. Should the estate receive a discount if the collection consists solely of one artist, which would flood the market and lower demand, ultimately decreasing the collection's value if sold? Several cases have appeared before the tax courts defending such discounts, such as *Estate of David Smith v. Commissioner of Internal Revenue*[33] and *Estate of Georgia O'Keeffe v. Commissioner of Internal Revenue,*[34] among others. Both estate planners and collectors should familiarize themselves with the technique and its potential pitfalls.

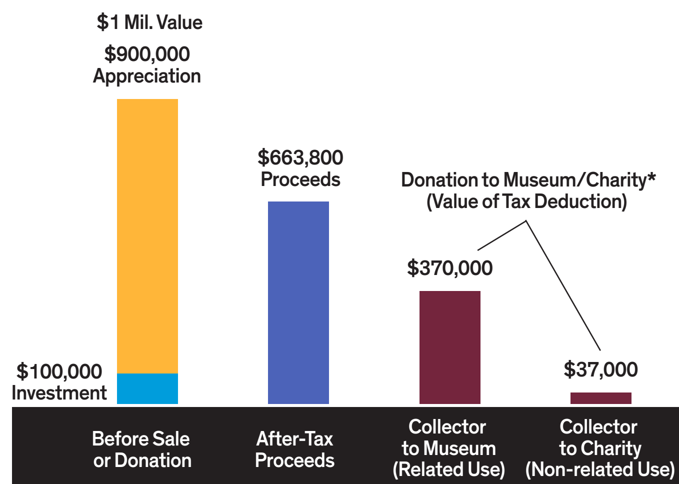
Non-financial concerns arise when waiting to transfer at death, whether through a sale, bequest, or trust direction. The presence of multiple beneficiaries is often the thorniest issue, as feelings of unfairness tend to emerge when one or more excluded beneficiaries do not benefit in a collection's post-death appreciation. One potential solution is to equalize the estate by passing the collection to those who desire it most while leaving a proportionate value of cash, bonds, stocks or other items to the remaining beneficiaries.

Transfers to Charity

Another way to plan with collectibles during life is through charitable giving. These strategies can be as simple as gifting to a museum or other charitable organization. Such donations may provide immediate income tax benefits through a charitable income tax deduction if certain requirements are met. The deduction's value is based on a usage test known as the related-use test. To achieve a deduction for fair market value, the charity or museum must use the gift as part of its tax-exempt mission. For instance, donating a classic car to a museum for sale at auction wouldn't pass this test, so the deduction would be based on your original purchase price for the car, not its current fair market value. For gifts of art to public charities or donor advised funds that do not meet the related use requirements, donors may deduct the lesser of cost basis or fair market value. However, that is limited to 50% of the donor's adjusted gross income (AGI) for cost basis and 30% for fair market value.[35]

Suppose you own a painting worth $1 million that you purchased ten years prior for $100,000, and you live in a favorable income tax state such as Florida or Texas. If you were to sell that painting, assuming a 5% commission and the requisite 31.8% federal tax rate, you would pay $336,200 and be left with $663,800 to invest. What if you donated that art to a charity that would pass the related-use test instead? The value of that donation could be worth up to $370,000, assuming a 37% top marginal income tax. In contrast, donating to a charitable organization that did not pass the related-use test would only be worth up to $37,000 in light of your $100,000 cost basis (*Display 6*).

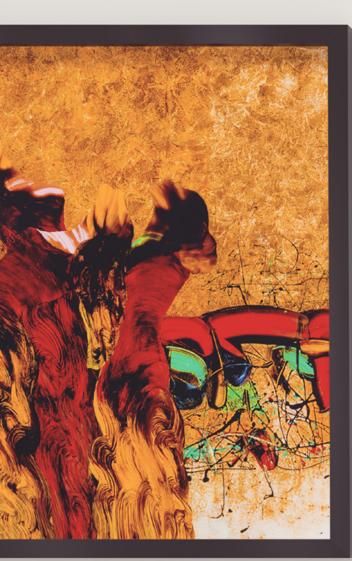
DISPLAY 6: TAXABLE SALE



*Section 170 of the Internal Revenue Code of 1986, as amended

Assumes collector is subject to 28% collectibles capital gain tax along with 3.8% NIIT surcharge as well as a 5% commission on the sale. No state or local income tax applied. Further assumes collector has top marginal federal rates and can apply the entire deduction upfront against their tax rate for a 37% federal tax rate.

33 Estate of David Smith v. Commissioner of Internal Revenue, 510 F.2d 479 (2d Cir. 1975)
34 Estate of Georgia O'Keeffe v. Commissioner of Internal Revenue, T.C. Memo. 1992-210
35 Any unused deduction may be carried forward for up to five additional years.



Private Museum

A private museum may be structured as a private operating foundation controlled by the donor provided that:

(i) the foundation expends funds annually in direct execution of its charitable purpose (which must be educational) in an amount equal to the lesser of (a) its adjusted net income, or (b) its minimum investment return; and

(ii) more than half of the foundation's assets are devoted to the foundation's primary activity (i.e., the operation of the museum).[38]

Given that the private museum's charitable purpose must be educational, public access is essential. The museum may meet this requirement through advertising, staying open for regular hours (or by appointment only), lending items from the collection, making the collection available for research, and hosting educational events that are open to the public. The IRS has held that merely offering visiting hours is insufficient to ensuring public access in the absence of advertisements or other indications that the museum is open to the public. There is very little guidance on how much public access suffices, so advisers typically recommend that private museums be generous and realistic when delivering public benefits.

Donation Agreement

Direct gifts to charity or charitable organizations during life should be accompanied by a donation agreement, which establishes proof of donation, sets expectations for both donor and recipient, and can be used for specific instructions surrounding the gift. For example, should there be a plaque describing the piece, who it was donated by, and where it should be displayed? If you want the items displayed in a certain manner, you may need to contribute additional funds. Establishing these guidelines in advance helps resolve any miscommunication between the two parties should they arise.

Charitable Giving Through Fractional Interest Donations

Another option is for the collector to take advantage of an IRS provision that allows the collectible to be donated over a ten-year period.[36] The charity will fully own the item at the end of this term—or at the collector's death if that comes sooner.

Under this provision, a work of art could be transferred to a museum over the course of a decade. Initially, the collector would contribute a portion of the work, say 25%, while committing to consummate the gift within the next ten years. The donor would be entitled to an income-tax deduction of 25% of the full value of the work (not a discounted value). In the ensuing years, the donor can keep the art in their home for a period of time that's proportional to their ownership (i.e., nine months each year for a retained 75% stake). In the fourth year of the term, the collector might give another 25% to the museum.[37] In this manner, the collector can extend their enjoyment of the art and take better advantage of their charitable deduction by spreading it out over a decade.

However, there are potential drawbacks. If the art appreciates during the years of partial ownership, the collector won't benefit. That's because each charitable income tax deduction is based on the lesser of the value at the time of the initial contribution or the value at the time of the subsequent contribution. What's more, there is a related use requirement for fractional interest donations. If the recipient does not use the property for its exempt purposes, the donor will incur penalties and loss of prior deductions. For that reason, the donation agreement should clearly describe how the charity will use the property for its exempt purposes.

36 IRC §170(o)
37 Note that the remaining partial interest gifts will not receive an additional charitable deduction.
38 IRC § 4942(j)(3)(B)(i)

Foundations and Donor Advised Funds

Donating to a private non-operating foundation is tricky due to the asset distribution rule, which states that the foundation must distribute at least 5% of its assets each year to charitable causes in order to maintain its tax-exempt status. There may also be issues with self-dealing if you continue to use the collectibles within the foundation (for instance, hanging art on your wall). Some collectors might consider forming a private museum or operating foundation for the collection, although this arrangement may be treated as a public charity, with the associated charitable deductions and benefits applying. Before proceeding, be sure to obtain careful legal advice. As an alternative, some collectors give the art or collectible to a Donor Advised Fund (DAF), which can sell the asset and provide a funding account for granting money to charities.

Testamentary Charitable Transfer Options

Some collectors decide to pass their entire collection to a qualified charity at death. Due to the unlimited estate tax charitable deduction, such transfers are not subject to estate tax, eliminating those ramifications from a planning perspective. However, donors should still work with the selected charitable beneficiaries during life to ensure they are prepared to accept the bequest when the time comes. The intended recipient of the collection may not want it or be able to properly care for it or show it as the collector intended.

For instance, an automobile collection bequeathed to a not-for-profit classic auto museum may not fit into the charity's existing collection. What's more, the charity may lack the funding or space to show or store the cars. While grateful, the charity may be forced to sell the collection, undermining the original intent. The outcome may have been different had the organization been given the chance to plan in advance or organize capital campaigns to ensure they'd have adequate funding to assume the collection.

Another potential strategy is a testamentary charitable lead trust (CLT). The trust can be structured so that the estate receives an estate tax charitable deduction for the collection's full market value. The collection can then be sold in the trust to fund an annual distribution to charity for a specified period, often between 10 and 20 years. Any remaining trust assets pass to the non-charitable beneficiaries at the end of the period as detailed in the trust instrument. Like the CRT strategy previously described, this approach assumes the collection will be sold as soon as practical.

Expert Help Is Essential

Transferring a collector's life work is a complex process that requires careful consideration of various strategies, beneficiaries, and timing. Seeking expert help from valuation experts, trust and estate experts, philanthropic teams, and wealth advisors like Bernstein will help ensure the collector's vision is achieved without unduly burdening the beneficiaries. With careful planning, the collector's love and passion can be passed on to future generations, whether during life or at death. Collectors with significant collections should seek professional guidance to understand the trade-offs and potential financial implications of the strategies proposed here and elsewhere. That way, they can ensure that their legacy is preserved, and their collection is used in a way that aligns with their values and goals.

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